Corporate Tax - Cyprus

Protocol to Cyprus-Russia double taxation agreement signed

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Following the signing of the protocol to the double taxation agreement between Cyprus and Russia during Russian President Medvedev's recent visit to Cyprus, it was anticipated that the amended agreement would be ratified by the Parliaments of both countries before the end of 2010 and take effect from January 1 2011. However, this did not prove possible within the parliamentary timetables and ratification is now expected to take place early this year.

The amended agreement retains the highly favourable tax provisions between the two countries and will strengthen Cyprus's position as a portal for inbound and outbound investment between Russia and the rest of the world.

The amendments introduced by the protocol extend the information exchange arrangements between the two countries' respective tax authorities in line with the Organisation for Economic Cooperation and Development (OECD) Model Tax Convention, and include strong safeguards to protect taxpayers.

The protocol also aligns the taxation of capital gains with the basis set out in the OECD Model Tax Convention. Under the new rules, taxation rights in respect of the capital gains derived on the sale of shares in a property-rich company will be conferred on the country in which the property is located. It is normal to give the right to tax capital gains on immovable property to the state which is entitled under the double taxation convention to tax both the property and the income derived therefrom, and the protocol follows this principle. It provides that gains derived by a resident of one contracting state from the disposal of shares deriving more than 50% of their value from immovable property situated in the other contracting state may be taxed in that other state. The exclusive taxing right will remain with the country of residence of the seller if:

- the disposal qualifies as a corporate reorganisation;
- the shares are listed on a recognised stock exchange; or
- the seller is a pension fund, provident fund or the government of either country.

Russia and Cyprus have not broadened the scope of the amendment (as some other states have done in their bilateral conventions), so that the source country taxation of capital gains will also extend to gains from the alienation of interests in other entities that do not issue shares, such as partnerships and trusts. In this respect it remains to be seen whether Russian limited liability companies will be caught by the new rule.

The protocol provides for a grace period of at least four years in relation to the new arrangements regarding taxation of capital gains. The relevant amended article will not become effective until the first day of the calendar year following four years after the protocol as a whole takes effect. This will be January 1 2016 at the earliest, giving time to consider and implement measures to mitigate any negative impact of the change.

The protocol clarifies the definition of 'dividends', regarding which there had previously been some uncertainty. Distributions from mutual funds and similar collective investment vehicles (other than those primarily investing in immovable property) will be subject to the normal withholding tax rates applicable to dividends. Distributions from shares held in the form of depositary receipts will also be taxed as dividends.

The definition of 'interest' has been aligned with the OECD definition and includes income from debt claims of every kind.

One of the most important aspects of the protocol is that there is no change to the extremely favourable withholding tax rates applicable to cross-border payments of dividends, interest and royalties.

Furthermore, Russia has undertaken that by the time the new provisions regarding taxation of capital gains come into force, it will have adopted the OECD Model Tax Convention provision for capital gains in its tax treaties with all states which are significant investors in Russia.

The Russian authorities are expected to announce the removal of Cyprus from any Russian tax 'blacklists' with effect from the date on which the protocol takes effect, thus making dividends received by Russian shareholders from qualifying equity participations in subsidiaries in Cyprus eligible for the Russian participation exemption.

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